United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-7382

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket Nos. 76-7382, 76-7399

CHARLES R. WOLFSON, *et al.*,

Plaintiffs-Appellants,

—against—

STEIN ROE & FARNHAM, *et al.*,

Defendants-Appellees and Cross-Appellants.

BRIEF OF DEFENDANTS-APPELLEES AND CROSS-APPELLANTS STEIN ROE & FARNHAM AND HENRY THIELBAR

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

PAGE

Statutes

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BRIEF OF DEFENDANTS-APPELLEES AND CROSS-APPELLANTS STEIN ROE & FARNHAM AND HENRY THIELBAR

This is an appeal from a judgment entered for defendants after trial in a derivative action brought by shareholders of two mutual funds, Stein Roe & Farnham Balanced Fund, Inc. ("Balanced Fund") and Stein Roe & Farnham Stock Fund, Inc. ("Stock Fund"), to recover on behalf of the funds for what plaintiffs contend was a breach of fiduciary duty in defendants' "artificially maintaining the separate existence" of the two funds for the "sole purpose" of charging the funds higher management fees (12A*).

Defendants cross-appeal from the District Court's failure to award them the costs of this action.

The District Court (Pierce, *J.*) found after trial to the Court that (i) the funds' board of directors had been at all

* References to " A" are to pages of the Joint Appendix.

times fully informed of both the expenses of each fund and the profit to the Adviser derived from managing the funds (192A) and (ii) that each fund's board of directors had, as to its fund, determined independently and consistently in the good faith exercise of its business judgment that the fees and expenses paid to the Adviser were fair and reasonable in amount (*Id.*). (It is a stipulated fact in this case that at all relevant times the "outside" directors were independent and not "interested" (33A)).

Plaintiffs do not challenge those findings on appeal.

The District Court dismissed the complaint, having concluded that, no matter what legal standard applied, plaintiffs had failed to establish their claims that the fees paid to the Adviser by the funds were excessive or that their receipt constituted a breach of fiduciary duty.*

The Questions Presented

1. Was it error for the District Court to hold that the fees paid by the funds to the Adviser—in terms of amount as well as manner of calculation—were a matter for determination by the funds' boards of directors in the informed exercise of good faith business judgment?

2. Was it error for the District Court to hold that the plaintiffs had failed to establish that the fees paid by the funds to the Adviser were so excessive as to constitute a breach of fiduciary duty, where the uncontroverted findings of fact are

(i) that the fees charged to the funds are lower than many others in the industry,

* The District Court's opinion is reported at [Current Binder] CCH Fed. Sec. L. Rep. ¶ 95,634 (S.D.N.Y., June 22, 1976).

(ii) that the funds' investment performance is "decidedly above average"

(iii) the funds' "fully informed" boards of directors "determined independently and consistently that all expenses and fees paid to the Adviser are fair and reasonable in amount," and

(iv) that the funds' shareholders voted "overwhelmingly" to approve the advisory contracts even after full disclosure of the plaintiffs' claims?

3. Was it error for the District Court to deny defendants the reasonable costs of this action?

Statement of the Case

A. The Parties

Balanced Fund, a Maryland corporation, is a diversified, open-end management investment company or "mutual fund" registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (the "Act") (32A, 187A). Its purpose is to provide its shareholders with a complete investment program (DX-DJ).* Its assets are invested in a diversified portfolio of bonds, preferred stocks and common stocks (32A, 187A). As of December 31, 1965 Balanced Fund had total net assets of \$114,575,885 (DX-BQ); as of December 31, 1975, its total net assets were \$137,390,057 (PX-161).

Stock Fund, a Maryland corporation, is also a diversified, open-end management investment company registered with the SEC under the Act (32A, 187A). It was organized in 1958, nine years after the Balanced Fund, to offer in-

* References to "DX- " and "PX- " are, respectively, to defendants' exhibits and plaintiffs' exhibits introduced at trial.

vestors a fund which would invest its assets primarily in common stocks (32A, 187A; DX-DJ). As of December 31, 1965 Stock Fund had total net assets of $57,375,332 (DX-CA); as of December 31, 1975 the total net assets were $163,228,496 (PX-149).

Each fund is a no-load fund.*

Stein Roe & Farnham (the "Adviser"), an Illinois limited partnership, is engaged exclusively in investment counseling (70A, 188A). The Adviser serves each fund pursuant to a separate investment advisory contract which is reviewed annually by each fund's board of directors. It is the investment adviser and manager for the funds: it makes investment and reinvestment decisions with respect to each fund's portfolio, subject to the overall control of each fund's board of directors, and manages the business and operations of each fund (188A). The Adviser also furnishes office space and extensive clerical and bookkeeping services to the funds (*Id.*).

The Adviser also performs investment advisory services for numerous individual and institutional clients. Total portfolio assets managed by the Adviser, including the funds, are approximately $4 billion (71A, 188A). Thus, Balanced and Stock Funds, with combined assets of approximately $300 million, comprise roughly 7.5% of the assets managed by the Adviser (71A-81A, 98A, 188A).

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* A "no-load" fund is a mutual fund in which a purchasing shareholder pays no sales charge ("load") in connection with his investment. Thus, the full amount paid by the investor is invested in shares of the fund without any deduction for commission or other sales charges. By contrast, in an ordinary fund the investor pays a sales commission of approximately 9% on his purchase of fund shares; his net investment is reduced by the amount of the load (90A-91A).

Section 10(d) of the Investment Company Act details the statutory scheme for a type of "no-load" fund. 15 U.S.C. § 80a-10(d).

Henry Thielbar is a partner of the Adviser, a director of Stock Fund and an officer of Balanced Fund.

B. History and Objectives of the Two Funds

Balanced Fund was organized by the Adviser in 1949 to provide investors whose assets did not warrant the costs associated with individual portfolio management the opportunity to own shares of a professionally managed, diversified securities portfolio (84A-85A, 189A). Balanced Fund offers to its shareholders a balanced investment program; in the past ten years, between 65% and 75% of Balanced Fund's assets were in common stocks; the remaining assets were fixed-income securities (85A). Common stocks with long term growth possibilities are selected for Balanced Fund, while, with respect to the bond portion of the fund's portfolio, emphasis is placed on acquiring high quality, non-speculative issues (189A; DX-BZ (p. 2)). As the fund's President testified:

> "To me it means that there is less risk to the owner of shares in a Balanced Fund than the risk of owning an all Stock Fund, because while bonds and other fixed income securities may fluctuate in value with changes in interest rates, their fluctuations are generally much less than the stock market, particularly as we witnessed in the last few years" (88A).

Stock Fund was organized in 1958 for investors who enjoy adequate fixed-income security from, for example, life insurance programs, annuities, pensions or social security benefits and who therefore already have a measure of protection in periods of recession and market decline (85A-86A, 189A-190A). Stock Fund is therefore almost fully invested in common stocks except when reserves of cash are held pending reinvestment or are deemed advisable to guard against extraordinary situations (86A, 189A-

190A). Common stocks are selected which, in the Adviser's opinion, have long-term appreciation possibilities (189A-190A).

Because the criterion for selecting common stocks for the two funds is identical, that is, long-term appreciation potential, it is not surprising (indeed, one would expect it to be the case) that the common stock portfolios of the funds are substantially the same (88A-89A, 190A-191A).*

C. Performance of the Funds

The uncontroverted evidence demonstrated and the District Court found that the investment performance of the two funds has always been "decidedly above average" (94A-96A, 190A). For example, reference to Wiesenberger's *Mutual Fund Performance Monthly* (April 1975) demonstrates that the funds' investment performances have placed both in the top half of all mutual funds reported, whether the comparison is over a period of ten years, five years, one year or the year-to-date (DX-CY).

D. Expenses of the Funds

Pursuant to the investment advisory agreements between each fund and the Adviser, each fund pays a management fee to the Adviser of 1/2 of 1% of the first $100 million of average net asset value plus 2/5 of 1% of average net asset value in excess of $100 million (189A; DX-DL, DX-DM).

A mutual fund's "expense ratio," the ratio of the fund's total expenses (management fee plus the other expenses paid by the funds) to total net assets, is a generally ac-

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* The SEC stated, in its landmark report to Congress on mutual funds: "Although the various funds in a single complex usually have somewhat different investment objectives, their portfolios often overlap to a substantial extent." *Report of the SEC on the Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 108 (1966).

cepted measure of a fund's expense performance (77A-79A). *Report of the SEC on the Public Policy Implications of Investment Company Growth*, *supra* page 6 n, at 97-100. Both Balanced Fund's and Stock Fund's expense ratios are, and have been for many years, among the lowest in the industry (79A).

Not only are the expenses of each fund well below the level prevailing in the industry, but, in addition, in contrast to much of the industry, the Balanced and Stock Funds are "no-load"—*i.e.*, the Adviser receives no sales charge or commission on the sale of shares to an investor (188A; *see* discussion *supra*, p. 4 n).

E. Approval of the Management Fee by the Boards of Directors

There are eleven Balanced Fund directors and twelve Stock Fund directors. Each board includes three "outside"* directors who are not "affiliated" with the adviser nor "interested persons" within the meaning of Sections 2(a)(3) and 2(a)(19) of the Act, 15 U.S.C. §§ 80a-2(a)(3), -2(a)(19). The same three outside directors serve on the boards of both funds; two of them testified at the trial (188A).** As previously noted, the independence of all three is conceded (33A).

* The Investment Company Act requires that one member of a no-load fund's board of directors not be an "interested person" as defined by Section 2(a)(19) of the Act. Section 10(d), 15 U.S.C. § 80a-10(d). The boards of Balanced Fund and Stock Fund nevertheless each have three such "disinterested" members.

** The present disinterested directors are: R. Douglass Cooper, President of R. Cooper, Jr., Inc., an independent distributor of Westinghouse Electric Corporation products; Lemuel B. Hunter, a private investor active in civic affairs, formerly a Vice-President of Inland Steel Company; and John Jeuck, Robert Law Professor of Business Administration, Graduate School of Business, University of Chicago (93A-94A, 112A-113A, 133A). Each has served on the boards of both funds since 1969.

As the District Court found, the two independent directors who testified at trial understood that they had a particular statutory duty annually to review and pass upon the management contract between the Adviser and each fund (116A-117A, 137A-138A, 193A). Section 15(c) of the Act stipulates that a majority of the independent directors of an investment company must approve the management contract in order for the board's vote of approval to be effective.

The District Court found that each fund's board of directors has been at all times "fully informed" of the expenses of each fund and of the profit or loss of the Adviser derived from managing the funds (116A-117A, 136A-137A, 192A-193A). It is self-evident that the directors of the funds were aware, as anyone would be, that had the two funds' assets been aggregated for purposes of fee calculation, and had the fee formula not been changed, the total fees paid by the funds would have been reduced (124A, 140A).

The disinterested directors of Balanced Fund and Stock Fund, with full knowledge of the facts, have regularly approved, unanimously, the investment advisory agreements (96A, 193A).

The judgment of each fund's board of directors that the fees paid by its fund to the Adviser, and all other expenses paid by the fund pursuant to the investment advisory agreement, were reasonable in amount was based on their review of detailed documentation of each fund's performance, operations and expenses (192A-193A; *see* discussion, *infra* pp. 14-17).

The boards of directors each receive annually a detailed "fund expense study" prepared by the Adviser (97A, 116A, 137A; DX-CK through DX-CX inclusive). The expense studies contain, for the year under study and for the four

previous years, the following information: gross management fees received by the Adviser from the fund under study; expenses, direct and allocated, incurred by the Adviser; net income of the Adviser from management of the fund, before and after taxes; net income of the Adviser expressed as a percentage of the fund's net assets and also of the gross management fees; and the actual amounts of management fees paid by the fund expressed as a percentage of its net assets. The expense studies are reviewed by an outside accounting firm and the accountants' opinion letter is distributed as part of each study. Finally, annexed to the studies is a schedule showing the expense ratios of the larger no-load mutual funds (97A-98A).

The boards of directors also receive quarterly reports of the funds' portfolio holdings (100A).

F. Approval of the Management Fee by Vote of the Shareholders

In addition to the regular review and approvals by the boards of directors, the shareholders of both funds have approved the investment advisory contracts on two occasions during the period in question—the Stock Fund shareholders in 1968 and 1972 and the Balanced Fund shareholders in 1969 and 1972 (DX-A, DX-B, DX-C, DX-D).

The overwhelming shareholder votes of approval at the 1972 meetings take on added significance in view of their occurrence after full disclosure to all shareholders of this litigation and plaintiffs' claims. Because plaintiffs commenced this action after proxy materials for the 1972 meetings had been mailed, a supplemental notice was sent to all shareholders of both funds which, as plaintiffs concede, "fairly summarized" the complaint (DX-DX). Although a proxy card was enclosed for shareholders who wished to change their votes, approval of the investment advisory contracts was nevertheless "overwhelming" (194A).

ARGUMENT

Summary of Argument

Plaintiffs contend that because of the substantial identity between the common stock portion of Balanced Fund's portfolio and the portfolio of the Stock Fund, the directors and the Adviser breached their fiduciary duties to each fund's shareholders by not calculating the management fee on the aggregated assets of both Funds.

Plaintiffs' theory is an exaltation of form over substance, as plaintiffs seem so candidly to concede by the statement in their brief (p. 28) that they do not challenge

> "the rate or dollar amount of the fee, because rates and amounts are subjects of bargaining, 'a matter of judgment on the part of the persons who pay for them'."

Plaintiffs' contention finds no support in any judicial decision, agency action or statute.

Sometimes posing their argument under the rubric of a "double charge," plaintiffs seek to obscure or ignore the legal issues determined by the District Court:

> (i) did the independent directors condone "gross misconduct or gross abuse of trust" (former Section 36, if applicable, of the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1, et seq.)?, or,
>
> (ii) did they authorize or permit willful conversion or embezzlement (Section 37 of the Act)?, or,
>
> (iii) were they guilty of "personal misconduct" in permitting the Adviser to charge the management fees (Section 36(a) of the Act)?, or,

(iv) did they, after June 14, 1972, breach their Section 36(b) fiduciary duty in determining that the management fee paid by each fund was reasonable?, or,

(v) did they breach some common law fiduciary duty?*

Defendants submit that no matter what the legal standard by which the defendants are judged, no matter what provisions of the Investment Company Act may be applicable and no matter what body of common law is applied to the case, the answer is the same: there is not a shred of evidence in the trial record that any defendant breached any duty to anyone.

The uncontradicted evidence reflects the common sense fact that what the outside directors considered, each year, was the fairness and reasonableness of the total dollar amount of the fee paid by each fund, bearing in mind the value and quality of the services rendered, the funds' investment performance and expense ratio and the competence and integrity of the Adviser's personnel.

Defendants contend that it was error for the District Court to deny them their statutory costs.

I.

Plaintiffs' Contentions Obscure The Only Issue—The Reasonableness, In Dollar Amount, Of The Fees.

The essence of plaintiffs' contentions is that the Adviser and the funds' directors had a duty to merge Balanced Fund and Stock Fund, or at least to aggregate their assets for purposes of computing the fee, in order to avoid what

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* Annexed as Appendix A to this brief are the following sections of the Investment Company Act: former Section 36, present Sections 36(a), 36(b), and 37.

plaintiffs term the "unjust enrichment" arising out of the separate imposition of the higher 0.5% fee rate on the first $100 million of each fund's net asset value.

By their reiteration of the argument that the Adviser "charges twice for the same service," plaintiffs obscure the fact that what they are really seeking is simply a reduction of $100,000 annually in the amount of total fees received by the Adviser from Balanced and Stock Funds.* Plaintiffs fail to comprehend that the *manner* of fee computation is not at all relevant; what is relevant here is whether the end result of the fee computation—the dollar amount of the fee—is so unreasonable that no director, in the good faith exercise of his informed business judgment, could approve it without breaching his fiduciary duty. Plaintiffs also fail to comprehend that had any formula yielded a fee which was so low that the Adviser could not continue to perform its duties at a reasonable profit, it would have been the obligation of the directors of each fund to act in the long-term best interests of the fund and change the formula to yield an appropriate fee (*See* 120A-121A, 140A-141A).

Stressing that there is substantial and wholly understandable similarity between the portfolio of the Stock Fund and the common stock component of the Balanced Fund portfolio, plaintiff leapfrogs to the conclusion that to the extent both funds hold the same stocks, the Adviser is unlawfully charging twice for the same service. However, the contracts between the funds and the Adviser do *not* measure the Adviser's compensation by the number of

* A $100,000 reduction would result, for example, if the 0.5% fee rate is applied to only $100,000,000 of the funds' assets rather than $200,000,000 and the 0.4% rate is applied to the remainder [0.5% – 0.4%) x ($100,000,000) = (0.1%) x ($100,000,000) = $100,000].

portfolio holdings, the velocity of portfolio transactions or a numerical count of the Adviser's investment decisions. The Adviser is *not* paid for individual investment decisions, but rather for the totality of its services—the management and administration of two separate funds having different investment objectives. As the record demonstrates, there is much more to the management of an investment company than the making of individual investment decisions (74A-76A; DX-BE, DX-BN).

The adviser manages investment accounts totalling approximately $4 billion in assets; the two funds comprise a relatively small part of its business (71A-72A, 98A; PX-149, PX-161). The Adviser makes substantially the same investment decisions for all of its clients whose investment objectives include the purchase of common stocks with long-term appreciation potential (89A).

If plaintiffs' arguments had any validity, all but the first client to receive the benefits of any particular investment decision would be entitled to receive it for nothing or at a reduced rate. Put another way, plaintiffs would have the law require that since the Stock Fund was not organized until nine years after the formation of the Balanced Fund, the Stock Fund was entitled to the services of the Adviser at a fee no larger than the additional incremental cost to the Adviser of managing a second investment company. Merely to state plaintiffs' position is to recognize its manifest absurdity.

In any event, plaintiffs' argument founders upon the terms of the two investment advisory contracts, which provide explicitly that the services of the Adviser to each fund are *not* to be deemed exclusive. Thus, paragraph 6 of each contract provides as follows:

> "6. The services of Manager to Fund hereunder are not to be deemed exclusive, and Manager shall

be free to render similar services to others so long as its services hereunder are not impaired thereby" (DX-BE, DX-BN).

At the core of plaintiffs' case is the premise that if the assets of the two funds were aggregated for purposes of fee calculation, the fee formula specified in the two contracts would remain the same. The evidence demonstrates, and the District Court found, that the premise is false (103A-104A, 120A, 140A-141A).

II.

Uncontroverted Evidence Demonstrates That Both Funds Are Efficiently And Competently Managed At A Cost Well Below The Industry Average.

The trial record demonstrates that both funds receive above-average service from the Adviser for below-average cost, all under the watchful eyes of three independent directors who are kept fully informed about every material aspect of the funds' operation. Plaintiffs, who devoted singleminded attention to the similarity in the funds' common stock holdings, offered no evidence to the contrary.

To summarize some of the more significant aspects of the funds' operation and performance: *First*, the funds' expenses of operation and administration are among the lowest in the industry (77A-79A; *see* the last pages of the Balanced Fund expense studies for expense ratio data: DX-CK (as of 12/31/66), DX-CL (12/31/67), DX-CM (12/31/68), DX-CN (12/31/69), DX-CO (6/30/71), DX-CP (12/31/71), DX-CQ (12/31/72), DX-CR (12/31/-73); *see also* DX-CZ and DX-DA).

Second, shareholders pay no sales commission or "load" when making purchases or redemptions of fund shares, and the Adviser receives no compensation for the sale of fund shares (90A-92A). The typical load fund, by contrast,

charges a sales charge of 7% to 9% on a purchase of modest size (91A).*

Third, as the District Court found, "the investment performance of each Fund has always been decidedly above average when compared to that prevalent in the industry" (96A, 190A). Whether the comparison is over a period of ten years, five years, one year or year-to-date, the *Mutual Fund Performance Monthly* (April 1975) shows that both funds have performed in the top half of all mutual funds reported (DX-CY (pp. 14-15); 96A).

Fourth, the Adviser has not reaped unreasonable profits by virtue of its management of the funds. The table appearing on the next page, which consolidates data from the expense studies (DX-CK through DX-CX inclusive), shows that the Adviser's net income, expressed as a percentage of gross fee, has averaged 13.40% for the Balanced Fund, 6.55% for the Stock Fund. It borders on the absurd to suggest that in permitting such levels of reward, the directors violated their fiduciary duty to the shareholders.

Fifth, the method of computing the management fees which plaintiffs attack—separate application of a fee formula to each of several funds in a fund complex—is shown by the evidence and was found by the District Court to be quite common in the mutual fund industry. Eleven of the 18 largest mutual fund complexes calculate the management fee separately on each fund (DX-DB). More importantly, at least four of the complexes which do aggre-

* The SEC report on mutual fund growth describes the sales load as "by far the most significant charge paid by mutual fund investors." The report also confirms Mr. Woods' testimony as to the average size of loads: "Rarely is the basic load less than 7.5 percent of the total price that the investor pays and it has not exceeded 9 percent." *Report of the SEC on the Public Policy Implications of Investment Company Growth*, *supra* page 6 n. at 204. The report also notes that the "overwhelming majority" of mutual funds are load funds. *Id.*

Summary of Expense Study Data 1966-1975

Year	Gross Fees	Expenses	Income	Income After Tax	Net Income (% of Fees)
1966	$543,219	$394,683	$148,536	$ 83,795	15.4%
	293,062	274,964	18,098	14,116	4.8
1967	633,499	468,838	164,661	92,124	14.5
	368,121	336,165	31,956	23,117	6.3
1968	737,593	533,282	204,311	103,585	14.0
	476,314	421,928	54,386	32,820	6.9
1969	767,363	534,830	202,533	101,161	13.2
	571,863	572,745	(882)	(882)	(.2)
1970	674,012	586,384	87,628	50,265	7.4
	553,324	552,605	719	561	0.1
1971	779,378	541,054	238,324	125,492	16.1
	686,536	573,063	113,473	63,166	9.2
1972	898,811	576,162	322,649	167,587	18.6
	844,095	617,486	226,609	119,644	14.2
1973	829,773	686,077	261,696	137,159	16.5
	830,120	622,695	207,425	110,067	13.3
1974	626,235	539,500	86,735	49,819	7.95
	652,173	625,173	27,110	20,054	3.07
1975	653,310	545,189	108,121	67,495	10.33
(est.)	741,233	652,024	89,209	58,054	7.83
Averages					13.40
					6.55

Key

Balanced Fund data appears on the first line of each entry; *Stock Fund*, on the second

gate assets for fee calculation purposes charge substantially higher rates of management fee than does the Adviser here. Thus, if the assets of the funds were aggregated for fee calculation purposes and if the fee formula was at the level prevailing in the industry, the funds would pay more rather than less (81A-84A).*

Sixth, as the District Court found, "the directors of each Fund have at all times been fully informed of the expenses of each Fund as well as of the profit to the Adviser derived from managing each Fund" (192A-193A). That finding is not challenged on appeal.

The uncontroverted evidence proves these funds to be inexpensively, efficiently, and effectively managed by competent people. Thus the only issue is whether, solely because of the substantial identity of the common stocks held by Balanced Fund and Stock Fund, the directors and the Adviser, knowing of this substantial identity, breached some duty owed the funds' shareholders by not calculating the management fees on the funds' aggregated assets. As the District Court found, there is no such duty.

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* Plaintiffs would disregard the telling evidence concerning the level of management fees in fund complexes which aggregate assets for purposes of fee calculation because

> "unlike all other sister funds managed by a common adviser, the two Funds here are not only managed in all aspects as one fund, but also have practically twin portfolios." (Plaintiffs' Brief, p. 3)

There is no support in the trial record for plaintiffs' assertion that funds in other complexes have less portfolio duplication than is the case here. As a matter of common sense, in funds having a common adviser, one would expect to find portfolio duplication to the extent that it was consistent with differing investment objectives. As stated in the *Report of the SEC on the Public Policy Implications of Investment Company Growth*, *supra* page 6 n. "Although the various funds in a single complex usually have somewhat different investment objectives, their portfolios often overlap to a substantial extent." *Id.* at 108.

III.

The Law Imposes No Duty To Aggregate.

Plaintiffs purported to base this action on the alleged violation of at least six separate sections* of the Investment Company Act and Investment Advisers Act. The District Court correctly held that, as to each, plaintiffs totally failed to carry the burden of proof.

A. The Statutory Sections

(1) *Former Section 36 of the Act—"gross misconduct" or "gross abuse of trust"*

In a Supplemental Pre-Trial Order, plaintiffs for the first time indicated a reliance on former Section 36 of the Investment Company Act, which was superseded effective December 14, 1970 by the 1970 amendments to the Act. 84 Stat. 1428. Even if plaintiffs could rely on that repealed section, they have not begun to meet its burden of proof. Section 36, before its amendment in 1970, authorized the SEC** to bring an action in the federal courts to enjoin "gross misconduct or gross abuse of trust." By no stretch of the imagination have plaintiffs shown any "gross misconduct or gross abuse of trust."

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* Plaintiffs rely on Investment Company Act §§ 36 [prior to 1970 Amendment], 36(a), 36(b) and 37, and Investment Advisers Act §§ 206 and 207 (Supplemental Pre-Trial Order (51A)). Sections 206 and 207 of the Investment Advisers Act prohibit "fraudulent practices or "willful" untruths or omissions. The record cannot support any such finding.

** Although Section 36 explicitly empowered only the SEC to seek injunctive relief against mutual fund officers and directors, investment advisers and certain others, the courts implied a private right of action. See *Tanzer v. Huffines*, 314 F. Supp. 189, 193 (D. Del. 1970); *Brown v. Bullock*, 194 F. Supp. 207, 245 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961).

(2) Section 36(a) of the Act—"breach of fiduciary duty involving personal misconduct"

When it amended Section 36 in 1970, Congress did two things. First, in Section 36(a) it authorized the SEC to bring suit against certain investment company affiliates if they have engaged in "any act or practice constituting a breach of fiduciary duty involving personal misconduct," thus easing the burden of proof in suits by the SEC. 15 U.S.C. § 80a-35(a). Second, in Section 36(b) Congress expressly created a new but limited private right of action for "breach of fiduciary duty in respect of" compensation paid by an investment company to its investment adviser and affiliated persons. 15 U.S.C. § 80a-35(b).

As a result, we submit, there is no private right of action under Section 36(a). In making explicit the right of individuals to proceed under Section 36(b), Congress eliminated any justification for an implied right of action under Section 36(a).* Two District Courts in the Southern District of New York have held exactly that: "Section 36(a), however, authorizes an action by the SEC, not by private individuals." *Monheit* v. *Carter*, 376 F. Supp. 334, 342

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* Prior to the 1970 amendments, the statute was silent on the subject of private actions and there was therefore much more room for implication. There is no longer any basis for reading a private right of action into Section 36(a) where Congress, while having the clear opportunity to do so, provided for none and where Congress instead expressly granted private litigants their remedy in the very next paragraph of the statute.

Although both the Senate and House reports on the 1970 amendments contain the statement that "[a]lthough section 36(b) provides for an equitable action for breach of fiduciary duty as does section 36(a), the fact that subsection (b) specifically provides for a private right of action should not be read by implication to affect subsection (a)", S. Rep. No. 91-184, 91st Cong., 1st Sess. 16 (1969); H. R. Rep. No. 91-1382, 91st Cong., 2d Sess. 38 (1970), the language of the statute is sufficiently clear that little light is shed by the committee reports. *See Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 750 n.13 (1975).

(S.D.N.Y. 1974). The District Court in this action agreed (194A).

However, assuming *arguendo* the existence of a private right of action under Section 36(a), even a proved breach of fiduciary duty would not, without more, create liability under Section 36(a). The explicit language of Section 36(a) requires more.

The central, distinguishing feature between Section 36(a) and Section 36(b) is the requirement that "personal misconduct" be proved in any action predicated on Section 36(a). Furthermore, the legislative history makes clear that the section

> "is intended to deal only with such violations committed by individuals. It is not intended to provide a basis for the Commission to undertake a general revision of the practices or structures of the investment company industry" S. Rep. No. 91-184, 91st Cong., 1st Sess. 36 (1969); H. R. Rep. No. 91-1382, 91st Cong., 2d Sess. 37 (1970).

As the District Court found, there is nothing in the trial record which could conceivably support a finding that any individual was guilty of "personal misconduct."

(3) *Section 37 of the Act—"willful conversion or embezzlement"*

Plaintiffs also purport to base this action on Section 37 of the Act,* which makes unlawful the willful conversion or

* The Supplemental Pre-Trial Order (51A) lists Section 37 as one basis for Count 1, covering the period prior to June 14, 1972, the date on which Section 36(b) became effective. Pub. L. No. 91-547, § 30(4), 84 Stat. 1436. At trial, plaintiffs' counsel corrected an obvious error in the Supplemental Pre-Trial Order by stating that Count 3, which also covered the period prior to June 14, 1972, was also based on Section 37, rather than on Section 36(b) (155A).

embezzlement of assets of an investment company and upon *Brown* v. *Bullock*, 294 F.2d 415 (2d Cir. 1961), which held that Section 37, *before the 1970 amendments to the Act*, authorized a private right of action. That case is no longer applicable, for now that Section 36(b) expressly authorizes a carefully circumscribed private right of action, Congress could not have intended the implication by the courts of a broader private right of action under Section 37. *See Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 750 n.13 (1975).

In any event, nothing in the record of this trial could conceivably support a finding that any defendant was guilty of "willful conversion" or "embezzlement" of fund assets. Plaintiffs' reliance upon Section 37 of the Investment Company Act is frivolous.

(4) Section 36(b) of the Act—"breach of fiduciary duty"

The legislative history of Section 36(b),* makes clear that Congress, while creating a private right of action in Section 36(b), did not intend to displace the business judgment of fund directors with respect to management fees.

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* This Section is effective only after June 14, 1972, Pub. L. No. 91-547, § 30(4), 84 Stat. 1436, by which time this suit had commenced and the directors knew about plaintiffs' theory (2A). *Plaintiffs did not attempt to rely on Section 36(b) to recover damages for any period prior to June 14, 1972* (51A-52A).

Section 36(b) and other 1970 amendments of the Investment Company Act were "one of the most carefully studied pieces of legislation to come before the Congress in recent years." Memorandum of the SEC on H.R. 11995 and S. 2224 to the Committee on Interstate and Foreign Commerce, House of Representatives, appearing in *Hearings on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess. 137 (1969).

The Senate report states it clearly: "This section is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees." S. Rep. No. 91-184, 91st Cong., 1st Sess. 6 (1969). The ultimate question before the District Court was, therefore, whether plaintiffs had proved that defendants violated their Section 36(b) fiduciary duty. The District Court found that plaintiffs made no such showing and those findings are amply supported by the trial record.

B. The Directors' Reasoned and Independent Business Judgment is Controlling

The District Court found that the plaintiffs had failed to establish any violation by defendants of their fiduciary duties and that, therefore, there was no reason to set aside the directors' informed business judgment.* Several factors sustain this determination.

Initially, plaintiffs can hardly be said to have proved a breach of fiduciary duty with respect to the fees paid to the Adviser when the funds' fees and expense ratios rank among the lowest in the industry. In determining whether a breach has occurred, the courts are to conduct precisely the comparative examination of industry practice which is undertaken periodically by these funds' directors. The Senate Report states that, in deciding whether the economies of scale have been properly shared with investors,

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* The District Court quoted Mr. Justice Brandeis for the general rule that

> "Courts interfere seldom to control such [directors' business judgment] discretion intra vires the corporation except where the directors are guilty of misconduct equal to a breach of trust . . . ." *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263-64 (1917).

"the best industry practice will provide a guide." S. Rep. No. 91-184, 91st Cong., 1st Sess. 6 (1969). It would seem that these funds should be the guide, not the guided.

Secondly, in concluding that plaintiffs failed to establish that defendants were liable for contracting for excessive fees in violation of Section 36(b), the District Court properly considered, as permitted by Section 36(b)(2),* approval of the fees by the funds' shareholders, particularly when that approval in 1972 came after full disclosure of plaintiffs' allegations with respect to the fees paid by the funds (194A, 197A). It is conceded that the disclosure to shareholders "fairly summarized" the complaint (DX-DX).

It is a critical fact here that plaintiffs make no allegation that the unaffiliated directors of the funds were dominated by the Adviser or that the unaffiliated directors had any personal interest in not merging the two funds. Indeed, they concede the independence of the unaffiliated directors (33A). They likewise could not, and did not, prove that the unaffiliated directors were less than fully informed of the facts relevant to their consideration of the reasonableness of the management fee paid to the Adviser.

Plaintiffs' reliance upon *Fogel* v. *Chestnutt*, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 45 U.S.L.W. 3250 (U.S., Oct.

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* Section 36(b)(2) reads.

"(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2).

5, 1976), and *Moses* v. *Burgin*, 445 F.2d 369 (1st Cir. 1971), is entirely misplaced. In both of those cases, advisers to mutual funds were held liable because they failed to fully and fairly present to the funds' disinterested directors matters as to which the advisers had conflicting interests, thus effectively precluding the exercise of independent business judgment by the directors.

Here, precisely the opposite is true. Here, as the District Court found, the three disinterested directors who served on the boards of both funds were at all times "fully informed" of everything relevant to the funds' management fees (192A). This appeal presents the wholly different case hypothesized by Judge Friendly in *Fogel* v. *Chestnutt*, 533 F.2d at 750—the case in which independent directors had all of the facts at their command and concluded as a matter of business judgment that the management fees were fair and reasonable and should not be changed.

Moreover, in this case, each of the three disinterested directors served both funds, so that each knew the portfolio composition of each fund. Each disinterested director knew that the common stock component of the Balanced Fund portfolio was substantially the same as the portfolio of the Stock Fund. It was as apparent to each director as it would be to anyone that *if* the assets of the two funds were aggregated for purposes of fee calculation and *if* the fee formula remained the same, the management fees paid by the funds would be reduced. In fact, prior to the institution of this litigation, the directors gave no advertent consideration to the theoretical possibility of aggregation; their focus—and properly so—was upon the fairness and reasonableness of the dollar amount of the fee. For the directors to have done otherwise would have been to exalt form over substance.

Accordingly, the well-established business judgment rule dictated entry of judgment for defendants:

> "Corporate management is vested in the board of directors. If in the course of management, directors arrive at a decision, within the corporation's powers and their authority, for which there is a reasonable basis, and they act in good faith, as the result of their independent discretion and judgment, and uninfluenced by any consideration other than what they honestly believe to be the best interests of the corporation, a court will not interfere with internal management and substitute its judgment for that of the directors to enjoin or set aside the transaction or to surcharge the directors for any resulting loss." H. Henn, *Corporations* 36A (1961).

The law is well established in this Circuit and elsewhere* that where informed directors make an honest business decision, the courts will not substitute their judgment for that of the directors. For example, in *Fogelson* v. *American Woolen Co.*, 170 F.2d 660 (2d Cir. 1948), Judge Swan stated that:

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* *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261, 263-64 (1917); *Ransome Concrete Machinery Co.* v. *Moody*, 282 Fed. 29, 32-33 (2d. Cir. 1922); *McQuillen* v. *National Cash Register Co.*, 112 F.2d 877, 883-884 (4th Cir.), *cert. denied*, 311 U.S. 695 (1940); *Doherty* v. *Mutual Warehouse Co.*, 255 F.2d 489, 490 (5th Cir 1958); *Greene County National Farm Loan Ass'n* v. *Federal Land Bank*, 152 F.2d 215, 219 (6th Cir.), *cert. denied*, 328 U.S. 834 (1945); *Midland Savings & Loan Co.* v. *Dunmire*, 68 F.2d 249, 252 (10th Cir. 1933); *Consolidated Cement Corp.* v. *Pratt*, 47 F.2d 90, 93 (10th Cir. 1931); *Wall & Beaver Street Corp.* v. *Munson Line*, 58 F. Supp. 109, 116 (D. Md. 1944), *Levitan* v. *Stout*, 97 F. Supp. 105, 114 (W.D. Ky. 1951); *Gruber* v. *Chesapeake & O.R.R.*, 158 F. Supp. 593, 603 (N.D. Ohio 1958); *Wiles* v. *Campbell*, 77 F. Supp. 343, 349 (D. Del. 1948). See also 3A W. Fletcher, *Cyclopedia on the Law of Private Corporations* § 1039 (Rev. ed. 1975) for a general discussion of the "Business Judgment Rule."

> "Courts are properly reluctant to interfere with the business judgment of corporate directors; they do so only if there has been so clear an abuse of discretion as to amount to legal waste." *Id.* at 662 (citations omitted).

See also United Copper Securities Co. v. *Amalgamated Copper Co.*, 244 U.S. 261, 263-64 (1917); *Ransome Concrete Machinery Co.* v. *Moody*, 282 F. 29, 32-33 (2d Cir. 1922).

The uncontroverted evidence at trial showed that the expense ratios of Balanced Fund and Stock Fund are among the lowest in the industry and that their performance is among the best. Furthermore, the expense studies show that the Adviser did not reap unreasonable profits from the funds' management.

The fact is that Balanced Fund and Stock Fund are well-run and skillfully managed mutual funds whose performance, by whatever yardstick is chosen, exceeds the industry average. This showing, together with repeated, regular shareholder and non-affiliated director approval of the management fees defeats plaintiffs' claim of "unjust enrichment" or "waste" and "spoliation" of the funds' assets arising out of the investment advisory agreements.

IV.

Defendants Should Be Awarded The Reasonable Costs Of This Action.

This District Court initially awarded defendants the costs of this action but reversed itself shortly thereafter to hold that "each party shall bear its own costs" (204A). Defendants contend that in the circumstances of this case the District Court's original award should be reinstated.

Costs are generally awarded to the prevailing party "as of course" unless the court directs otherwise. Fed. R. Civ. P. 54(d). While the award of costs is discretionary in the District Court, it has been held that

> "The denial of costs to the prevailing party . . . is in the nature of a penalty for some defection on his part in the course of the litigation as, for example, by calling unnecessary witnesses, bringing in unnecessary issues or otherwise encumbering the record . . . ." *Chicago Sugar Co. v. American Sugar Co.*, 176 F.2d 1, 11 (7th Cir. 1949).

The Seventh Circuit further stated that costs should be denied the prevailing party only where its acts, made in bad faith, tended to prolong and make the litigation unduly expensive "except where it is clear that the action was brought in good faith, involving issues as to which the law is in doubt," *id.*, in which case the court may order each party to bear its own costs. *See generally* 6 J. Moore, *Federal Practice* ¶ 54.70[5] (3d ed. 1976).

This action, riddled as it is with absurd contentions and manifestly unsound conclusions, did not raise issues as to which there could be any doubt. For example, plaintiffs' brief simultaneously states that the dollar amount of the fee is irrelevant (Plaintiffs' Brief, p. 28) but that defendants should be held liable for violating Section 37, which prohibits willful conversion, larceny and embezzlement. Furthermore, plaintiffs admit that there is no precedent for their claims (*id.* at 18).

Defendants submit that plaintiffs should be ordered to bear the costs of this action.

CONCLUSION

Since plaintiff proved at trial no basis for imposition of liability, judgment was properly entered for defendants. The judgment should be affirmed, and costs, both at trial and on appeal, should be awarded to defendants.

Respectfully submitted,

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November 24, 1976

APPENDIX

Section 36, Investment Company Act of 1940, as amended in 1970, 15 U.S.C. § 80a-35:

"(a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 80a-1(b) of this title.

"(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with

respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consid-

eration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this title for the purposes of sections 80a-9 and 80a-49 of this title, section 78o of this title, or section 80b-3 of this title, or (B) for an injunction

to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section." (Aug. 22, 1940, ch. 686, title I, § 36, 54 Stat. 841, Dec. 14, 1970, Pub. L. 91-547, § 20, 84 Stat. 1428.)

Section 36, Investment Company Act of 1940, 54 Stat. 841:

"The Commission is authorized to bring an action in the proper district court of the United States or United States court of any Territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after August 22, 1940, and within five years of the commencement of the action, of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts:

(1) as officer, director, member of an advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate." (Aug. 22, 1940, ch. 686, title I, § 36, 54 Stat. 841.)

Appendix

Section 37, Investment Company Act of 1940, 15 U.S.C. § 80a-36:

"Whoever steals, unlawfully abstracts, unlawfully and willfully converts to his own use or to the use of another, or embezzles any of the moneys, funds, securities, credits, property, or assets of any registered investment company shall be deemed guilty of a crime, and upon conviction thereof shall be subject to the penalties provided in section 80a—48 of this title. A judgment of conviction or acquittal on the merits under the laws of any State shall be a bar to any prosecution under this section for the same act or acts." (Aug. 22, 1940, ch. 686, title I, § 37, 54 Stat. 841.)

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

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CHARLES R. WOLFSON, et al., :		
Plaintiffs-Appellants, :		Docket Nos.
-against- :		76-7382 76-7399
STEIN ROE & FARNHAM, et al., :		
Defendants-Appellees and : Cross-Appellants.		

- x

STATE OF NEW YORK)
: SS.:
COUNTY OF NEW YORK)

DOROTHY M. SCHLIP, being duly sworn, deposes and says that she is over the age of twenty-one years; that she is employed by the firm of Sullivan & Cromwell, attorneys for Stein Roe & Farnham and Henry Thielbar; that on the 5th day of January, 1977 she served the within Brief upon the following attorneys at the following addresses by depositing two true copies to each, securely enclosed in a postpaid wrapper in the Post Office Box regularly maintained by the United States Government at 48 Wall Street, Borough of Manhattan, City and State of New York, directed to said attorneys at said addresses as follows:

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Sworn to before me this
5th day of January, 1977.

George A Scholz
Notary Public

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